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Petitioner,

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Respondents.

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TABLE OF CONTENTS

PAGE

I. THE QUESTIONS PRESENTED FOR REVIEW REQUIRE RESOLUTION OF IMPORTANT ISSUES OF LAW BUT DO NOT REQUIRE RESOLUTION BY THIS COURT OF ISSUES OF FACT 1

A. Whether Fairness Depends Solely And Conclusively On Stock Market Prices Presents Only An Issue Of Law—Although A Critical One In Determining Damages In A Merger Made In Violation Of §§ 14 And 28 Of The Securities Exchange Act Of 1934 1

B. The Court Of Appeals' Misinterpretation Of The Measures Of Damages Laid Down By This Court In *Ute* (Defendants' Profits) And In *Mills* (Petitioner's Reduction Of Earnings) Calls For Correction And Clarification By This Court 6

C. The Court Of Appeals' Absolute Denial Of Attorney Fees Without Hearing By The District Court Was In Plain Violation Of The Mandate 10

CONCLUSION 12

CITATIONS

Cases

Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) 6, 8

Bigelow v. RKO Pictures, 327 U.S. 251 (1946) 9

Borg v. International Silver Co., 11 F.2d 147 (2d Cir. 1925) 3

Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 516 F.2d 172 (2d Cir. 1975), rev'd other grounds, ... U.S. ....., 51 L. Ed. 2d 127 (1977) 7

David J. Greene & Co. v. Schenley Industries, Inc., 281 A.2d 30 (Del. Ch. 1971) 3

Exercycle of Michigan, Inc. v. Wayson, 341 F.2d 335 (CA 7, 1965) 9

Gallois v. West End Chemical Co., 185 Cal. App. 2d 765, 8 Cal. Rptr. 596 (1960) 3

Gerstle v. Gamble-Skogmo, Inc., 332 F. Supp. 644 (E.D. N.Y. 1971), aff'd, 478 F.2d 1281 (2d Cir. 1973) 9

Hannigan v. Sears, Roebuck & Co., 410 F.2d 285 (CA 7, 1967) 9

Lebold v. Inland S.S. Co., 82 F.2d 351 (CA 7, 1936), 125 F.2d 369 (1942) 3

Levin v. Mississippi River Corp., 59 F.R.D. 353 (S.D. N.Y. 1973) 3

Mills v. The Electric Autolite Co., 396 U.S. 375 (1970) 6-11

Pepper v. Litton, 308 U.S. 295 (1939) 3

Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (CA 3, 1974) 8

Talley Industries, Inc., SEC Investment Company Act Release No. 5953 [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶77,774 (1970) 3

Statutes and Rules

Securities Exchange Act of 1934—
§ 14(a), 15 U.S.C. § 78n(a) 1, 11
§ 28(a), 15 U.S.C. § 78bb(a) 1, 6, 7

Supreme Court Rule 21(4) 11

Other Authorities

Brudney and Chirelstein, Fair Shares In Corporate Mergers & Takeovers, 88 Harv L. Rev. 297 (1974) 5

O'Neal, Oppression of Minority Shareholders, (1975) .. 3

Stern and Gressman, Supreme Court Practice, (1969) .. 11

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-331

ELMER E. MILLS,

Petitioner,

vs.

THE ELECTRIC AUTO-LITE COMPANY, MERGENTHALER LINOTYPE CO. and AMERICAN MANUFACTURING CO., INC.,

Respondents.

REPLY OF PETITIONER TO BRIEF IN OPPOSITION

I. THE QUESTIONS PRESENTED FOR REVIEW REQUIRE RESOLUTION OF IMPORTANT ISSUES OF LAW BUT DO NOT REQUIRE RESOLUTION BY THIS COURT OF ISSUES OF FACT.

A. Whether Fairness Depends Solely And Conclusively On Stock Market Prices Presents Only An Issue Of Law—Although A Critical One In Determining Damages In A Merger Made In Violation Of §§ 14 And 28 Of The Securities Exchange Act Of 1934.

The court of appeals did not hold merely that "market price should be the *primary* gauge of value." Opp. 17.[1] It held, as a *matter of law*, that the market quotation for

[1] Respondents' Brief in Opposition is referred to as "Opp.". Other abbreviations are as in the Petition ("Pet.") and Opp. Emphasis is ours unless otherwise stated.

shares traded is the *sole* determinant of corporate value and of merger fairness, and that all other standard criteria for valuation such as prospective earnings and book value are irrelevant. This unprecedented legal rule was the sole basis for reversal of the district court, for its supposed error of law in giving reasonable weight to other factors. The court of appeals' entry of final judgment rests solely upon its novel rule of law that no other evidence bearing on reasonable value may be considered. (Pet. 8-21). Respondents' quotation from the opinion (Opp. 17) omits the critical sentences from the key paragraph at App. 16a-17a which we italicize:

> "*We hold that when market value is available and reliable, other factors should not be utilized in determining whether the terms of a merger were fair.* Although criteria such as earnings and book value are an indication of actual worth, they are only secondary indicia. In a market economy, market value will always be the primary gauge of an enterprise's worth. In this case thousands of shares of Auto-Lite and Mergenthaler were traded on the New York Stock Exchange during the first part of 1963 by outside investors who had access to the full gamut of financial information about both corporations, including earnings and book value. *If we were to independently assess criteria other than market value in our effort to determine whether the merger terms were fair, we would be substituting our abstract judgment for that of the market. Aside from the problems that would arise in deciding how much weight to give each criterion, such a method would be economically unsound.*"

In their zeal to conjure up issues of fact and in apparent recognition that the holding below cannot stand as written, respondents thus misstated the opinion below. Respondents, by their revision of the decision,

seemingly signify their agreement that the opinion is "inherently illogical" (Pet. 9, n.1) and that its market price exclusiveness test is indefensible.

If the ruling below is not "unprecedented" (Opp. 17), it is odd that respondents have cited no case (Opp. 18-19)[2]

[2] In *Borg*, Opp. 18, the court did not hold that market price is the exclusive measure of damages or fairness but did say that the value of industrial stocks depends "chiefly on what they will earn" and that book value is significant when it can be realized on "liquidation" (11 F.2d at 152). Considering the book value facts here (see Pet. 14, 20-1), which respondents ignore, *Borg* supports petitioner. None of the cases cited at Opp. 18, n.18 holds that market price is exclusive. Further, *Levin* involved approval of an arm's length settlement agreement (59 F.R.D. at 369) and recognized book value "would have relevance if there were prospect of . . . liquidation". (Here Autolite liquidated at or substantially above book value $83 million in assets before and after the merger (Pet. 20-1); *David J. Greene* involved an injunction, not damages, and the court noted the "basic reality" that the parent's control could depress a subsidiary's market price (281 A.2d at 35); and *Gallois* involved an appraisal statute unique to California but even then the court noted that evidence of "earnings, book values and prospects would be admissible" (8 Cal. Rptr. at 601) and that market price would be disregarded when the directors acted unfairly to the shareholders (*Id.* at 601, 602) (as here, see Pet. 13-18).

Respondents do not mention specifically *Lebold* (Pet. 9-10; Opp. 18, n. 17), the prior holding of the Seventh Circuit, which is contrary to the opinion below but consistent with *Pepper v. Litton*, that all elements of value that arms' length bargainers would consider, and not just market price, must be taken into account in determining the fairness of a transaction between a fiduciary parent corporation and its subsidiary. Respondents indirectly attempt to distinguish *Lebold* on the ground that *Autolite* does not involve a "squeeze-out" (Opp. 13); but a merger is a classic squeeze-out of the minority. F. O'Neal, *Oppression of Minority Shareholders* (1975), § 5.13, p. 254; § 5.31.

Respondents' attempt (Opp. 18, n. 17) to distinguish petitioner's cases fails: each of these cases holds that market price cannot be the exclusive test of fairness and in *Talley Industries*, at p. 83,792 the SEC squarely ruled that it did consider market prices but refused to give them "controlling weight . . . especially where, as here, one [company] is controlled by the other". See Pet. 10.

holding that market price is the exclusive measure of damages.

If the court of appeals had held merely that market price is the *primary* factor it necessarily would have had to consider other factors, even if "secondary." But it held all other factors were irrelevant and, contrary to what respondents say (Opp. 9), refused to consider the relevant evidence.

In an effort to prove the merger was fair on the basis of non-market criteria and post-merger data, respondents have loaded their brief with data, purported "facts" and other criteria and made erroneous and misleading arguments based on them. Since the court of appeals rejected as a matter of law all indicia of fairness other than market price it is unnecessary for this Court to consider such evidentiary matter and arguments. Accordingly, petitioner does not reply to such arguments.[3]

[3] Our silence is with considerable restraint in light of the misleading character of respondents' assertions. For example, in an effort to show merger fairness by some post-merger criteria, respondents state that an Autolite shareholder's dividends might have increased (only for those who did not convert promptly into common) from $2.40 to $5.90 or 146% (Opp. 15, n. 14). But during the same period the Mergenthaler shareholder's dividend increased from $1 to $3.15, or 215%. Similarly, while Autolite stock might have appreciated from June 1963 to November 1968 by 222%, during the same period Mergenthaler shares appreciated by 308% (Opp. 15; DX 108-A, B). Further, those Autolite shareholders who failed to convert (about 5%; Tr. 5595) suffered a substantial market loss (Tr. 361, 5610; PX 36). The post-merger earnings ratio of 4.85 also indicates the unfairness of the actual (1.88) or "effective" (2.31) merger ratios. See App. 7a-8a; Pet. 20, n. 2. The merger also reduced Autolite's book value immediately from $88.01 to $67.91 or 23% (PX 1, p. 15).

Respondents do not mention relevant pre-merger evidence such as that from 1961-3 Autolite's earnings increased 77% while Mergenthaler's earnings, divorced from Autolite's, dropped 29%. (Tr. 5237). As to other pre-merger standard criteria, see Pet. 19-21.

The basic issue remains one of law:

> Did the court of appeals correctly forbid the trial court to consider and weigh the evidence of customary criteria of fairness, substituting instead a single and conclusive test—market price for a few months before and one month[4] after the merger, especially where, as here, the terms and timing of the merger were controlled by the parent fiduciary corporation?[5]

Respondents insist that the merger was fair based on earnings for the hand-selected 6 months ending March 1963 (Opp. 6, n.7). Their view betrays their breach of trust and is: (1) contrary to their proxy representations (Pet. 4, n.1); (2) contrary to the holding below that earnings are irrelevant and market prices the exclusive measure of fairness (Pet. 8-9); and (3) contrary to *their* expert's advice that such a short period provides no reasonable basis for determining value (Pet. 19). Further as to the breach of trust, the 6 months earnings selected were designed by and permitted respondents, who were fiduciaries, to benefit themselves and take advantage of

[4] In ruling the transaction to be fair as a matter of law, the opinion below capitalizes upon the temporary and evaporating market price of the preferred shares given in payment by respondents. An Autolite shareholder who converted his preferred into Eltra common immediately suffered a direct market loss from the merger, while if he waited to convert, he lost again by virtue of the penalty ratio. The value assumed in the decision below could in fact have been realized only by shareholders who sold the preferred immediately thereby giving up their interest completely. The ruling assures immunity to any defendant clever enough to offer securities with a perishable market appeal.

[5] Respondents assert (Opp. 20-1) that the court of appeals also employed a "liberal formula" adopted from *Fair Shares* (Pet. 12, n.1) but in fact the "formula" is contrary to *Fair Shares* (Pet. 27, n. 2) and was taken from respondents' brief in the court of appeals, pp. 53-5. In any event the "formula" is limited to market prices for a few months before and one month after the merger.

their beneficiaries. Thus, 54% of these 6 months of Autolite's increasing earnings were included, for the first time (and not just the dividend income), in *Mergenthaler's* earnings which were also augumented, for the first time, by the "deferred credit" income arising from Autolite's book value, all timed under a plan carefully orchestrated by respondents. Respondents breached their trust to the minority by postponing a merger to gain the $25.5 million "benefits" of a majority stockholder and then using Autolite's book value to increase Mergenthaler's value and market price while timing the merger to withhold critical facts from the market place favorable to Autolite's market price (Pet. 13-21). By making market price for a few months controlling as to fairness, the opinion below not only sanctions deceptive proxy statements (Pet. 12) but also immunizes respondents' fraud, overreaching and breach of fiduciary duty.

B. The Court Of Appeals' Misinterpretation Of The Measures Of Damages Laid Down By This Court In *Ute* (Defendants' Profits) And In *Mills* (Petitioner's Reduction Of Earnings) Calls For Correction And Clarification By This Court.

Respondents do not deal with the essential holding of the court of appeals that whatever the post-merger evidence reveals, no recovery may be based on it if the merger was fair based on market prices just before and after the merger. (App. 6a-9a) This holding presents only a question of law, but an important one which was decided contrary to the mandate and in conflict with other decisions of this Court and the courts of appeals. (Pet. 21-25). The ruling below cannot stand: it permits a wrongdoer to profit from his wrong if the transaction was fair when consummated in direct disobedience to this Court's command in *Ute* that damages under § 28 of

the 1934 Act are the amount of the defendant's profit flowing from the wrong when this measure exceeds plaintiff's loss in the transaction itself, and in direct disobedience to the mandate of this Court in *Mills* that plaintiffs may recover for their "reduction of earnings or earnings potential".

Nor do respondents challenge the inescapable fact that the opinion below *itself* establishes that respondents *did* profit and were unjustly enriched, and that the Autolite minority in fact suffered a reduction of their earnings potential. By the merger, Mergenthaler increased its share of Autolite earnings from 54% to 73%, and gave up in return 27% of whatever Mergenthaler might earn. The $7 million difference in these actual earnings percentages (Pet. 25-6) provides a minimum measure under either test. But whatever the amount, there is no issue of fact that respondents *did* profit and petitioner *did* suffer an earnings reduction.[6]

---

[6] Contrary to Opp. 11, n. 10, petitioner did not reduce his damage claim from $69 million in the district court to $29 million in the court of appeals. The former included pre-judgment interest (PX 36) while the latter did not (Pet. Ct. App. Reply Br. 87, n. 1). Petitioner did ask the court of appeals to enter judgment for $42 million, the " 'minimum amount of damages that the district court could have awarded without committing reversible error'. *Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 516 F. 2d 172, 187 (2 Cir. 1975)*" [now reversed on other grounds, ... U.S. ....., 51 L.Ed. 2d 127 (1977)] Id. at 130. To end this long and hard fought litigation petitioner resolved any possible objections or uncertainties in the record in respondents' favor which reduced the $69 million to $42 million ($29 million plus pre-judgment interest of $13 million). *Id.* at 53-62, 107-127; Pet. Ct. App. Reply Br. 13-35, 87, n. 1.

The $7 million resulted from and is based entirely on the court of appeals' findings and conclusions respecting respondents' own records. (Pet. 25-6; Pet. for Rehg. 25-7). Under *Chris-Craft, supra*, and the court below's findings as to post-merger earnings, this Court could remand to the district court for entry of a $7 million judgment (plus pre-judgment interest) without further trial.

Contrary to respondents' assertion, the court of appeals did not affirm that "respondents had not profited at the expense of the Auto-lite minority (App. 6a) * * *" (Opp. 13).[7] The court, at App. 6a, simply rejected petitioner's reliance on the "intracorporate transfers". While this rejection was erroneous (Pet. 26, n.1), respondents do not dispute that the $7 million "*in no way* depends" on the intra-corporate transfers. (Pet. 26). Respondents simply have no answer to the $7 million damages established in the opinion below. The court of appeals rejected this recovery simply because it misconstrued this Court's *Ute* measure as confined to profit measured by market prices at the time of the exchange itself, excluding subsequent gains. App. 7a. This misinterpretation stultifies this Court's decision by converting two separate measures of damages into one.[8] By this misreading of the controlling authority, the Seventh Circuit also places itself in direct conflict with the Third. *Rochez Bros.*, 491 F.2d at 417.

Of course, respondents argue that there was a commingling of the assets and operations. (Opp. 10-11). But no real question of fact is presented on this issue. The basic question is did the district court actually find there was such a commingling. Petitioner says "no" (Pet. 26-28); respondents say "yes". The answer lies in reading

[7] Indeed, respondents assert that the merger resulted in a profit to Mergenthaler shareholders of at least 37½¢ a share (Opp. 6), which is about $1 million to Mergenthaler as a whole. This explains the $989,567 referred to at Opp. 11, n.10. As to the other figures there cited see n.6, *supra*.

[8] The district court correctly construed the mandate and concluded that "relief based upon post-transaction events may be granted. . . even if the securities transaction was itself fair at the time of consummation. *Affiliated Ute*, 406 U.S. at 155; *Mills*, 396 U.S. at 389; *Rochez Bros.*, 491 F.2d at 411 and 416-7." App.45a.

the district court's opinion at App. 53a-57a and in determining whether, as a matter of law, "assets" that can be commingled to defeat damages in a merger made in violation of the proxy rules include "quality of management" and "synergy". See Pet. 26-8.

In its prior opinion this Court did not say that *any* commingling could defeat direct proof of damages. It required such commingling as would make it "*impossible* to establish direct injury from the merger". (Pet. 5) The issue is not (Opp. 11) what Autolite might have earned had it remained a separate entity: commingling of the actual operations would be irrelevant to that speculative question. Under *Mills*, the issue is rather what actual post-merger earnings were in fact obtained.[9] Neither

[9] The court of appeals also said that the district court found that Eltra's financial statements were misleading because they "underestimated the expenses of the Auto-lite divisions" (App. 8a). The district court concluded "that Eltra Central, a separate central service unit in Eltra's consolidating statement, was charged with certain expenses" not allocated back to the operating divisions (App. 55a). But respondents never offered any proof of specific sums to be charged to the Autolite divisions and were barred from impeaching their own records. See cases cited at Pet. 28: *Bigelow*, 327 U.S. 251, 265; *Exercycle of Michigan*, 341 F.2d 335, 337; *Hannigan*, 410 F.2d 285, 293; and *Gerstle*, 332 F.Supp. 644, 647. More importantly, while Eltra Central's total (1963-72) expenses were nominal or non-existent in relation to Autolite's and Eltra's income, petitioner advised the court of appeals that he did adjust Autolite's 1963-72 income by charging against it "a full proportionate share of all Eltra Central's expenses . . ." (Pet. Ct. App. Br. 58). Further, Eltra Central had a net expense only by excluding the "deferred credit" income (Pet. 14). By including the "deferred credit" income in Eltra Central as respondents' statements do, Eltra Central had *net income* for 1963-72 as a whole. The court of appeals, moreover, by stating Mergenthaler's (Eltra's) income as $58 million (App. 7a) included therein the deferred credit income. Therefore, in computing the $7 million loss to petitioner and gain to respondents (Pet. 25-6) no further adjustment for Eltra Central expenses is required since Eltra Central had net income, not expense.

"synergy" nor "quality of management" makes that determination impossible.

C. The Court Of Appeals' Absolute Denial Of Attorney Fees Without Hearing By The District Court Was In Plain Violation Of The Mandate.

Even if this Court were to grant *certiorari* and affirm the court of appeals on the damage issue, this Court should still reverse and remand to the district court to determine whether petitioner is entitled to attorneys fees and expenses incurred subsequent to the establishment of respondents' liability. That is precisely the question this Court left open for the *district court* to determine after *hearing* (396 U.S. at 390, n.13). The court of appeals' preemption of the district court's role is contrary to the mandate. Pet. 28-30. Respondents (Opp. 21-23) do not deal with this aspect of the prior mandate.[10]

Was petitioner supposed to abandon the case or at his peril finance its prosecution? Was he to penetrate the intricate and detailed corporate transactions revealed in this record unaided by experts or accountants? Was he not to explore whether "commingling of the assets and operations [made] it *impossible* to establish direct injury from the merger" or whether "the merger resulted in a reduction of the earnings or earnings potential" of the minority's holdings? Was he not to inform "the sound discretion which guides the determinations of courts of equity" so that the district court might pass upon "[p]ossible forms of relief. . . . includ[ing] setting aside

[10] Respondents do argue that the bad faith exception to attorney fee awards is not applicable here (Opp. 22), but this question, as it bears on fees, was never argued in the district court *or* the court of appeals. That is because the entire question of fees in the absence of damages was never presented to the district court or argued in the court of appeals. See Resp. Ct. App. Br. 89; Pet. Ct. App. Br. 127-9.

the merger or . . . other equitable relief"? (*Mills*, at 386, 389). Was he to do all of this at his own expense and peril? Petitioner was charged with fully vindicating the strong public policy expressed in the 1934 Act, particularly § 14(a) (*Mills* at 382), and he *did* produce a monetary award in the district court.[11]

And if this Court affirms the court below's wholly new and unprecedented rules that market price alone shall be the determinant of fairness and that a wrongdoer may profit from his wrong if the transaction was fair—rules which, had they been the law at or before trial, might have lessened substantially, if not obviated, petitioner's trial burden and preparation, should that ruling equitably be applied retrospectively to deny petitioner's fees and expenses with relation to that burden?

[11] Regarding Opp. 2, n.1, prior to filing the instant Petition counsel for plaintiffs were advised repeatedly by counsel for respondents that if this petition were filed, respondents would file a cross-petition asking this Court to reconsider its prior decision as to fees and expenses and to deny plaintiffs all attorney fees and expenses. When counsel for plaintiffs communicated these threats to plaintiffs, Mr. Susman became concerned he might not recover expenses he advanced and asked to be dropped as a petitioner even though counsel advised him that he could not foresee such a result. Mr. Susman's reluctance to proceed exemplifies the inevitable result of the holding below denying legitimate expenses of future prosecution of derivative claims. Shareholders will no longer be willing or able to prosecute on behalf of their corporation, which has been rendered incapable of asserting its own cause of action by the unlawful merger itself, and defendants will thus acquire complete immunity for their violations of federal law as the inevitable consequence of those very violations.

We do not believe that Supreme Court Rule 21(4) was violated since Mr. Susman still has an "interest in the outcome of the petition" as a shareholder in the corporation on whose behalf the suit was brought and his interest is the same as and protected by petitioner. We did not think that under these circumstances Rule 21(4) applied, see Stern and Gressman, *Supreme Court Practice* (1969), § 6.30, but if we erred we apologize.

In keeping with this Court's prior direction, the order of remand should leave to the district court's decision, in the proper exercise of its jurisdiction to make findings in the first instance, the whole question of the appropriate award of litigating expenses and fees, both before and after this Court's prior decision, with the absence of damages to be considered as one "factor", as this Court decreed.

CONCLUSION

For the reasons stated above and in the Petition, petitioner respectfully requests that this Court grant a writ of certiorari and reverse the judgment below.

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